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> **The deficit country is absorbing more, taking consumption and investment together, than its own production; in this sense, its economy is drawing on savings made for it abroad. In return, it has a permanent obligation to pay interest or profits to the lender. Whether this is a good bargain or not depends on the nature of the use to which the funds are put. If they merely permit an excess of consumption over production, the economy is on the road to ruin.**
>
> **— Joan Robinson, *Collected Economic Papers, Vol. IV*, 1973**

RESTRUCTURING THE U.S. ECONOMY— DOWNWARD

Finally, the greatest boom in American housing history is going bust. The impact on the economy has only just begun to be felt. Demand for homes is sharply down, while the number of vacant dwellings is ballooning — up more than 40% for existing homes and more than 20% for new homes year over year. At issue now is the severity of the impending bubble aftermath.

It does not seem, though, that there is a lot of worrying around. There appears to be a widespread belief that the U.S. economy is now out of trouble because the Fed decided not to raise interest rates. We presume the following interpretation:

1. This is not just a pause, but the end of all rate hikes.
2. In the absence of an overheating economy, inflation is yesterday's issue.
3. Steady or lower interest rates will boost the stock market.
4. As the Fed no longer tightens, the possibility of a hard landing can be dismissed.
5. Abundant liquidity continues to underpin the markets.

Treating bad economic news as good for the financial markets, Wall Street is running wild with more aggressive speculation. *"The world economy is on track to grow at a 5.1% rate this year, but the risk of a severe global slowdown in 2007 is stronger than at any time since the September 2001 terror attacks on the United States,"* said the International Monetary Fund in a report to finance ministers, mentioning two possible triggers: a sharp slowdown in the U.S. housing market or surging inflationary expectations that would force central banks to raise interest rates.

Taking this forecast into account, the sudden plunge of commodity prices may not be totally surprising. On the other hand, prices of risky assets and mortgage-backed securities have, despite the obvious problems in U.S. housing and consumer finance, held steady. Stock prices of U.S. lenders up to their necks in subprime, interest-only and negative-amortizing mortgages have been rising 5–10% since late August. Since hitting bottom in June, emerging stock markets have rebounded 20%. Developed international markets have risen by 12%, and U.S. stock markets by around 8%. A vertical slide by the yen since May suggests that yen carry trade is back with a vengeance.

Given the growing talk of impending recession in the United States, all this may appear rather surprising. The underlying rationale seems to be the assumption that this recession will be just another soft patch forcing the Fed to what the speculative community likes most: a return to easier money.

There is talk of recession, but definitely no recession scare. Popular perception appears to trust that the U.S. economy will again prove its outstanding resilience and flexibility. And are the balance sheets of private households not in excellent shape, as rising asset valuations have vastly outpaced the rise in liabilities over the years? The

possible scary parts of the new development, a deeper recession and a precipitous decline in economic growth, have not yet come to the fore.

Over the past five years of recovery from the 2001 recession, U.S. economic growth has been "asset driven," according to colloquial language. More to the point, protracted sharp rises in house prices served private households as the wand providing them with prodigal borrowing facilities to increase their spending. For years, it was the economy's single motor. The Fed estimates that mortgage equity withdrawals exceeded $700 billion, annualized, in the first half of 2006.

In 2005, the last full year for which data are available, new borrowing by private households amounted to $1,241.4 billion. Now compare this with the following spending and income figures. Disposable personal incomes grew $354.5 billion in current dollars and $93.8 billion in inflation-adjusted dollars. Spending increased $530.9 billion in current dollars and $264.1 billion in chained dollars.

THE SHALLOWEST RECESSION, BUT…

We have presented these figures to highlight the paramount importance of the large equity extractions on the part of private households for U.S. economic growth during the U.S. economy's current recovery. Plainly, it prevented a much deeper recession. Absence of any wealth gains could have easily induced private households to do some saving out of current income.

For the consensus, the U.S. economy's shallow recession in 2001 is the most splendid justification of Mr. Greenspan's repeatedly expressed idea that it is better to fight the bubble's aftermath with easy money than to prick it in its prime. This is plainly a gross misjudgment, because America's shallowest recession was followed by five years of the shallowest economic recovery, with unprecedented large and lasting shortfalls in employment, income growth and business fixed investment.

Actually, there have been major changes in the U.S. economy's pattern of employment and resource allocation, but altogether changes for the worse, not for the better. These structural changes are bound to depress U.S. economic growth in the long run.

The striking feature of the housing bubble — distinguishing it diametrically from an equity bubble in this respect — is its extraordinary credit and debt addiction. The reason is that it requires borrowing for two different purposes: *first*, for driving up house prices; and *second*, for the cash out of the capital gains. Every single dollar for this purpose has to be borrowed.

Since end-2000, American households have offset their badly lacking income growth with an unprecedented stampede into indebtedness, up so far by $5.3 trillion, or 77%. But as soaring house and stock prices added a total of $15.6 trillion to the asset side of their balance sheets, households miraculously ended up with an unprecedented surge in their net worth from $41.5 trillion to $53.8 trillion in the first quarter of 2006.

Referring to this fact, Fed Chairman Bernanke noted in a speech on June 13 that *"U.S. households overall have been managing their personal finances well."*

Manifestly, the rapid creation of the housing bubble in 2001 did prevent a deeper recession. But this should raise the further question of how the housing bubble and its financial implications have affected the U.S. economy from a longer perspective. In other words, are they in better or worse shape today than in 2001 to weather the aftermath of the housing bubble? Our answer is categorical: Underlying cyclical and structural conditions have dramatically worsened.

In 2001, the Greenspan Fed could cushion the fallout from the bursting equity bubble with the creation of the housing bubble. This time, manifestly, there is no alternative bubble available to be inflated to cushion the fallout from the housing bubble. Rather, there is a high probability that the popping housing bubble will pull the stock market down with it. That is the first ominous difference between 2001 and today.

The second ominous difference is that the economy and the financial system have accumulated structural

imbalances and debts as never before in history. Vastly excessive borrowing for consumption and speculation has turned the U.S. economy into a colossus of debts with a badly impaired capacity of income creation.

And finally, equity and real estate bubbles are very different animals, of which the latter is manifestly the far more dangerous. In its *World Economic Outlook* of April 2003, the International Monetary Fund published a historical study, titled *When Bubbles Burst*, and explained differences in the effects between bursting equity and housing bubbles. It stated, in brief, the following:

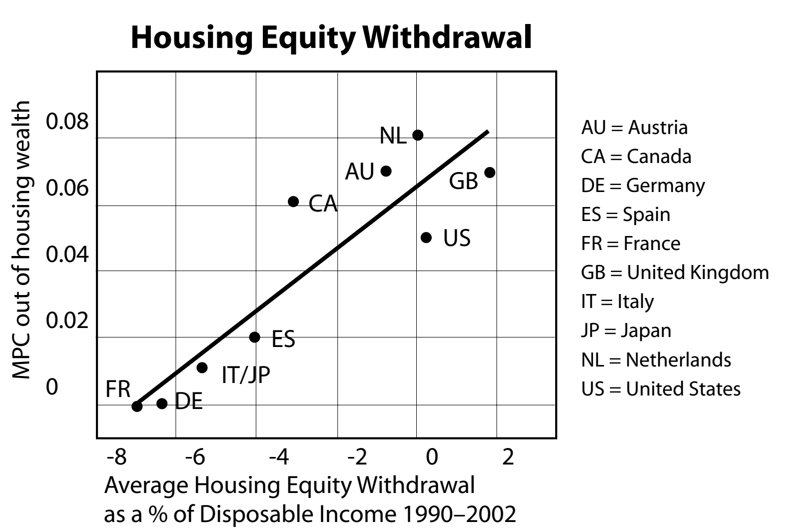
> First*, the price corrections during housing price busts averaged 30%, reflecting the lower volatility of housing prices and the lower liquidity in housing markets.* Second*, housing price crashes lasted about four years, about 1 1/2 years longer than equity price busts.* Third*, the association between booms and busts was stronger for housing than for equity prices…* Fourth*, all major bank crises in industrial countries during the postwar period coincided with housing price busts.*

The severe cases of bursting housing bubbles badly affecting the banking systems in the late 1980s were in England, the Nordic countries and Switzerland, not to speak of Japan, where, however, commercial real estate played the key role.

TWO DIFFERENT HOUSING BUBBLES

All major housing bubbles, which mainly happened during the late 1980s, did serious damage to the economies concerned and their financial systems. Price bursts were inexorably followed by price crashes. Mentioning this, we hasten to add that the housing bubbles of the past were in a most important respect diametrically different from the present U.S. housing bubble.

Those old-fashioned ones were pure price bubbles. Mortgage borrowing exclusively served to finance purchases of residential property. The novelty in the United States and several other countries since 2000 is the large-scale extraction of equity from housing through borrowing against housing collateral in excess of investment in residential property. This really is the specific feature that qualifies an economy as a "bubble economy."



Source: Bank for International Settlements, 75th Annual Report (Average 1990–2002)

Heavy equity withdrawal against rising house prices in the past few years has, in fact, become the specialty of the English-speaking countries, involving unprecedented increases in indebtedness for spending on consumption. Typical macroeconomic counterparts everywhere are plummeting domestic savings and ballooning trade deficits.

One common factor linking this group of countries is the extraordinary ease with which housing equity can be withdrawn against rising house prices. In most other countries, it remains an abhorred practice. First of all, the whole idea of "wealth creation" is repudiated. France, for example, has had among the steepest rises in house prices over the past few years. Yet as equity withdrawal remains taboo for bankers and others, the personal savings rate has remained stubbornly above 11% of disposable income.

THE FINAL RECKONING

As the housing bubbles pop, consumer spending is sure to slow in all these countries.

The severity of this reaction is the great question. At best, alternative demand components are ready to take over. Essentially, these would have to be business fixed investment or net exports. What are the chances of this happening in the U.S. case?

America's economic recovery since 2001 has in many ways been unlike anything else ever experienced in the long annals of the business cycle. Its decisive shortfalls have been in business fixed investment, employment and income growth, particularly from wages and salaries. Actually, all three shortfalls show no improvement.

The day would come, has been the argument, that the customary cyclical dynamics of job and income generation would take over, allowing the abolishment of the artificial demand stimulation through the asset bubble.

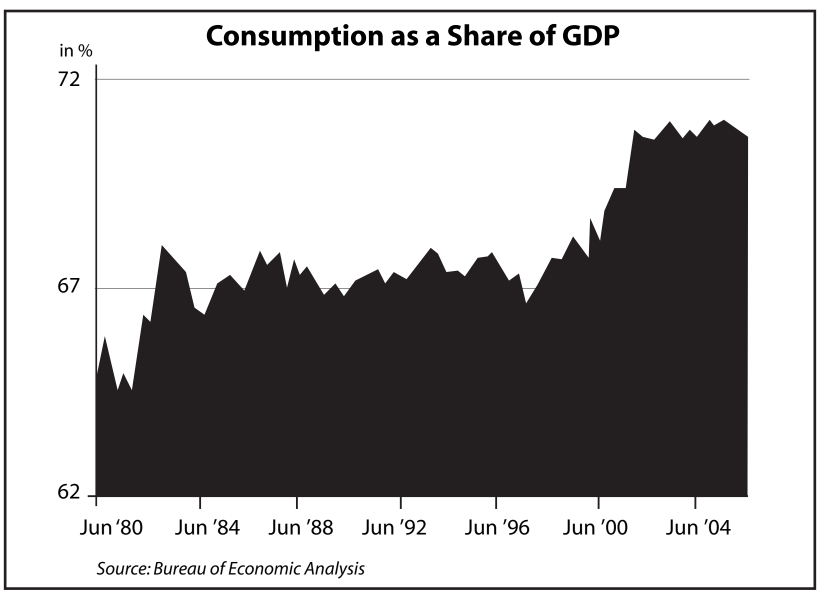
In the 1930s, it was customary to speak of government deficit spending as economic "pump priming." This process was common in the old days of the well and the cistern. It consisted of pouring water into the top of a dry pump and then working vigorously at the handle until the pump began to operate again in a normal way. It was an artificial expedient put into temporary use, but it succeeded only when the pump itself had been in good working order.

The analogy with fiscal and monetary pump priming to stimulate economic growth is self-evident. Both will not and cannot succeed in restoring self-sustaining economic growth if the economy is not in good working order. To be sure, after its extraordinary borrowing-and-spending excesses of the past few years, the U.S. economy is no longer in working order to resume self-sustaining economic growth.

It is patently clear that this U.S. economic recovery never reached the stage where it became self-sustaining. After a temporary slight improvement thanks to the huge tax cuts, disposable personal growth is at its worst. In 2005, the rate of real disposable income growth was down to a record low of 1.2%. This compared with a rise in inflation-adjusted spending by 3.5%. In the year before, this relationship had been +3.9% in real expenditures and +3.6% in real disposable income.

THE KEY SHORTFALL: BUSINESS FIXED INVESTMENT

What went wrong with the U.S. economy's recovery? The short answer is unprecedented credit and debt excess fueled three outsized bubbles: housing, consumption and financial speculation. Their macroeconomic counterpart has been a gross neglect of business fixed investment.



Reasonable aggregate GDP growth gave the appearance of a rather normal recovery. But its composition all the time has been very badly structured. Economic and financial imbalances existing in 2000 have all dramatically worsened. Savings collapsed further, while the trade deficit more than doubled. Consumer indebtedness exploded, while income growth imploded. Yet we would specify the protracted sluggishness of business fixed investment as the single most important failure.

To make economic growth self-sustaining, as we have emphasized many times in the past, requires by all means "adequate" investment spending

being the one GDP component that drives economic growth both from the demand and supply sides. The first boost to economic growth derives from the investment spending and the associated production of the capital goods, and the second boost to economic growth sets in when these capital goods are installed and start their own production.

And there are two further most important particularities to business fixed investment. One is that through the depreciations, it is self-financing, therefore involving no debt growth. And the other particularity of crucial importance is that the sequence of new investment, depreciations and their reinvestment creates an endless self-sustaining spending and income stream.

Every major economic crisis in history had its decisive cause in a lack of capital investment, never in a lack of consumption. Failure to restore adequate capital spending was the single most important cause of the U.S. Great Depression in the 1930s, and it is again the main cause of Japan's protracted recession.

It can be argued that where there is adequate capital spending in an economy, all ingredients of prosperity — higher employment, higher incomes, higher profits, higher consumption and higher productivity — will take care of themselves. Adequate capital investment is completely missing in today's America — and in many other countries.

CONSUMPTION IMPOVERISHES

In the case of consumer spending, the relationship with debt growth is diametrically opposite to that in the case of capital investment. Consumer borrowing impacts the economy once and for all. Any further increase in spending requires further borrowing. As debts pile up, interest costs pile up, at the expense of future income.

There is in reality no net gain in spending power for the consumer from borrowing. Principally, he only pulls future income and future spending into the present. His future income will, in addition, be lowered by the interest expense. This makes sense for people with rising income. For people who are heading for retirement with lower incomes, however, it spells disaster.

"*The usual effect of the attempts of government to encourage consumption, is merely to prevent saving; that is, to promote unproductive consumption… and diminish the national wealth by the very means which were intended to increase it,*" wrote the famous British economist John Stuart Mill in 1829 in a paper "Of the Influence of Consumption on Production."

Manifestly, U.S. policymakers have no reason to rejoice at the overall economic and financial effects of their "asset-driven" consumption-led recovery. If you look at anything other than the highly dubious GDP and productivity figures, you discover nothing but unprecedented shortfalls and imbalances.

For people at large, the reality is stagflation. Weekly and hourly wage rates today, adjusted for inflation, are no higher than they were in 2000. There are only 2.5% more jobs than in recession year 2001. That is barely one-fourth of the average employment growth in past recoveries.

The great boast about the economic recovery is the unprecedented rampant wealth creation through rising asset prices. With this rosy perception of wealth creation, though, American policymakers and economists are quite alone in the world. We regard this postulate as a deliberate and systematic delusion of the public to camouflage the true gross economic failures of this economic recovery.

True wealth creation implies more than the possibility to sell an owned asset at a higher price. Many people may feel richer. Yet the true value of an asset depends on the related income. Plainly, the rising house prices do not reflect expectations of higher incomes from the houses. They reflect one thing only, and that is the hope of the owners for a greater fool to buy it later at a higher price.

Speaking of wealth creation, it is necessary to strictly distinguish between increasing plant for production, generating current and future income, and mere increases in valuations of existing plant. Only the former adds to future income; the latter does not. This makes the decisive difference between true and imaginary wealth creation.

But isn't it nevertheless a gain for the individual? In reality, he, too, gains nothing. It is pure inflation in the

sense that within the price system, house prices are taking a leap. The person who takes a profit has to give it up again when he changes residence of the same standing. Even from the individual perspective, it is entirely phantom wealth creation.

This so-called wealth creation through rising asset prices implicitly arises from the practice to treat all existing assets of that kind as being worth the price of the last trade. According to this convention, minimal turnover is able to generate most fantastic wealth gains — simply by a stroke of the pen.

There is false and there is genuine wealth creation. In principle, there are only two ways a generation can take care of its future retirement. One is to accumulate foreign wealth by running a trade surplus, and the other is to increase the economy's productive domestic capital stock. Manifestly, phony wealth creation through rising house and stock prices has the diametrically opposite effects in both respects: soaring foreign indebtedness, on one hand, and a stagnating, if not shrinking, productive capital stock, on the other.

The obvious reason is that the phony wealth creation through inflating house and stock prices has driven consumer borrowing and spending to gross excess as a share of GDP. Given the economy's limited production capacity, this essentially pulled resources away from capital formation and the trade balance. From the macro perspective, this represents a clear case of general impoverishment, assuring a generally falling living standard.

DON'T BLAME PRODUCTIVITY GROWTH

It has become the conventional and convenient explanation that the U.S. economy's miserable income growth during the past several years has its main cause in its superior productivity growth. But strangely, this record-high productivity growth also coincides with zero growth in real wage rates. Record-low employment growth plus record-low wage rate growth have been producing record-low income growth for the large working population.

To prevent the U.S. economy from sliding into its deepest postwar recession required the rampant rise in house prices enabling people to replace their missing income growth through an unprecedented borrowing binge. Altogether, this is another unique economic experience in history, and we would not say that it appears a reasonable way of economic growth.

Though it seems quite plausible that high productivity growth might cause unemployment, it has never happened in history. Strong productivity growth is typical of a booming economy with booming capital investment. Their common cause being strong capital investment, strong productivity growth has in the past always correlated with high employment and income growth.

The strange thing about the U.S. economy's performance during the past few years is that reported record-high productivity growth coincided with record-low capital investment.

CAPITAL SPENDING — THE MISSING LINK

In 2000–01, the U.S. economy abruptly slowed under the impact of an unusually steep fall in business fixed investment, lasting until the first quarter of 2003. The high-tech investment bubble burst. While the Fed was unique in the world in the speed of its rate cuts, the government was unique in the world in the speed and size of its fiscal stimulus through tax cuts and deficit spending. The trouble is that only consumer spending responded.

Business fixed investment has not really recovered from its prior slump. Compared with its peak in 2000, it is up a paltry 5.8%. But this compares with simultaneous GDP growth by 16.1%. Consumption is up 19.5%, residential building 34.8% and government spending 16.1%, all in real terms.

Even this paltry increase in business fixed investment derives more than fully from hedonic pricing of computers. The amount actually spent on computers over the same period fell from $109.3 billion to $86.2 billion.

But hedonic pricing of computers, reflecting increases in computational power, instead created a stunning increase in computer investment by 86.4%, to more than $500 billion, in chained dollars. As the Bureau of

Economic Analysis suppresses these dollar figures in real terms, we had to make our own calculation from available older figures.

To put it bluntly, hedonic pricing plays a major role in the U.S. GDP statistics, adding heavily to capital investment and in further sequence to real GDP and productivity growth. But it has to be realized that it measures spending that has never taken place, and actual spending alone generates employment, incomes and profits.

THE INEVITABLE CREDIT SQUEEZE

There is no question that the rapid creation of the housing bubble in 2001 has prevented an immediate deeper recession. But in the face of the bursting housing bubble, it has to be asked how this second bubble has affected the U.S. economy and its financial system. Are they, as a result, in better or in worse shape than five years ago?

Bubble economies originate in extraordinary credit excess, which has always ended in a credit collapse. In the U.S. case, the debt growth associated with the housing bubble belongs to the worst cases in history. Strikingly, it sharply accelerated over the years. It began with a credit and debt increase by $655.2 billion in 2001 and hit its strongest increase with $1,338.4 billion, annualized, in the fourth quarter of 2005.

Over the five years from 2000–05, private households increased their outstanding home mortgages by $3.9 trillion — or 82% — to $8.7 trillion. On the asset side of their balance sheets, they simultaneously reaped capital gains from rising house prices by $8.5 trillion. In essence, the rising house prices, offering vast borrowing facilities, were crucial in driving U.S. economic growth.

As we have repeatedly stressed in past letters, the financial system has been defying the Fed's rate hikes all the time with a sharply accelerating credit expansion. All of a sudden, this has changed. According to the Fed's just published Flow of Funds Accounts, mortgage borrowing in the second quarter of 2006 has slowed to $1,096.8 billion, annualized, down 18% from its peak in the fourth quarter of 2005.

This still represents gross credit excess, yet it is the first cutback. But what is the reason? Has the Fed, after all, hit the brake? For sure, it has not. Nor will it ever do that. This abrupt credit slowdown has its reason in the rapidly vanishing house price inflation. Prices for new homes were up just 0.3% from July 2005, while prices of existing homes on average rose 0.9%. These are the smallest price increases in 10 years.

This brings us to the looming great policy dilemma. Given continuous dismal income growth of private households, future economic growth plainly remains heavily dependent on further borrowing. But these possibilities depend on further rises in house prices. It is important to stress a sharp consumer retrenchment in borrowing and spending by no means requires a precipitous decline in housing prices.

For that to happen, a flattening out of house prices is sufficient. In essence, this would on its own act as the most rigorous credit brake. Apparently, the U.S. housing market has reached this critical point, thus implying an impending drastic credit slowdown.

BUST BEAT BOOM

Definitely, the greatest threat to the U.S. economy and the various other bubble economies is a precipitous decline in house prices. For American policymakers and most economists, this seems unthinkable. We would not predict it, but it has a high probability in our view. An old rule of the Austrian School says that the severity of a bust is rather proportionate to the length and intensity of the prior boom.

Reason and historical experience, in our view, suggest that in cases where booms have gone to extraordinary excess, the damages from the later bust are, in general, asymmetrically much larger than the economic gains during the prior boom, and this for an obvious reason: the involvement of the financial system through bad loans.

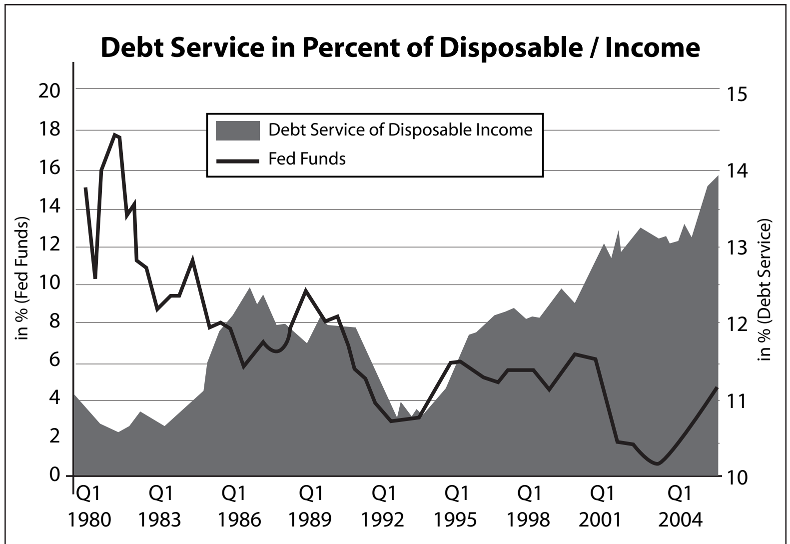
The question is whether there could possibly develop a situation in which heavy selling meets virtual

absence of buying. In the case of the stock market, it is very easy to organize concerted buying. But that is absolutely impossible in the case of real estate. It would require preposterous sums.

According to all reports, lenders in the United States went to unprecedented laxity to boost their mortgage loans. Considering, on the other hand, the unprecedented weakness in the current income growth of private households, we are sure that the stage is set for a pretty dramatic bubble aftermath.

Considering the steep rise in debts against the dismal income growth of private households, we suspect that very many house owners already belong to what Hyman Minsky has identified as Ponzi financing units. That is, unpaid interests are simply added to outstanding credit. We are pretty sure that such Ponzi finance is playing a sharply increasing role in boosting credit.

A second shocking fact to see is the U.S. economy's rapidly increasing debt addiction in the sense that GDP growth requires ever more debt creation. In 2005, it took a credit expansion of $3,335 billion for real GDP growth of $345.1 billion and nominal GDP growth of $743.3 billion. In 2000, similar GDP growth was achieved with credit growth of $1,630.8 billion.



Source: Federal Reserve

RESTRUCTURING DOWNWARD

Pondering the U.S. economy's extraordinary debt addiction, last but not least, we need to mention the huge U.S. trade deficit, running now at an annual rate of over $800 billion. Such a deficit and its counterpart, capital inflows, exert quite a variety of effects on the U.S. economy and its financial system. American policymakers and most economists focus exclusively on the effects they like, such as lower inflation rates and lower interest rates.

From their general talking, one has to conclude that they are totally unaware of the growing structural damages that the huge trade deficit does to the U.S. economy, both on its demand and supply sides.

On the demand side, as we have repeatedly pointed out, the trade deficit acts dollar for dollar as a subtraction from the current spending and income stream. In this amount, domestic spending is diverted from domestic to foreign producers. At close to 7% of GDP, this drag has reached a magnitude that would drive the U.S. economy into recession.

To offset this spending and income drag, compensatory demand creation through new credit creation is required. This is what the Federal Reserve has been readily delivering for many years with wide-open money and credit spigots.

True, the money promptly returns through the capital account. But what those capital inflows buy are not American products. They buy existing assets, mainly U.S. bonds. The crucial point to see here, which American policymakers and most economists flatly overlook, is that these return flows end up adding nothing to spending and incomes in the economy, which the import surplus has decreased.

Sharply increasing the U.S. economy's credit and debt dependence is the first evil effect of the large trade deficit. But in addition, there are major structural effects. The persistent additional credit expansion causes demand and output distortions that permeate the whole economic structure.

These structural distortions arise from the fact that the spending and income effects from the additional credit expansion essentially differ from those that get lost through the trade deficit. In this way, the trade deficit

is substantially changing the U.S. economy's whole structure.

Its obvious cardinal victim in the U.S. case is manufacturing, having lost a total of 3 million jobs since 2000. The question now is where the additional credit expansion has been creating the new jobs.

In its Sept. 25, 2006, issue, *BusinessWeek* carried as its cover story an article titled, **"What's Really Propping up the Economy."** The shocking short answer was, ***"Since 2001, the health care industry has added 1.7 million jobs. The rest of the private sector? None."***

America's big job loser is manufacturing. Its big job creator during the past five years, with 1.7 million jobs, is mainly health care and related industries, of which 478,000 jobs were added by hospitals. Construction and real estate-related industries — mainly construction, mortgage lending and real estate brokers — altogether added around 940,000 new jobs, and the government sector (except hospitals) added around 900,000 new jobs.

The rest of the private sector lost 1.2 million jobs, as job losses in manufacturing vastly exceeded the direct and indirect job gains through the housing boom. Makers of computers and electronic products shed more than 500,000 U.S. jobs, while telecom companies cut more than 300,000 jobs.

BusinessWeek failed to pose the most important question about this distinct change in the U.S. economy's job structure — the question of its cause. Evidently, the lopsided pattern in job growth reflects the lopsided growth pattern of the whole economy. But what caused the latter?

For this kind of change in the structure of an economy, Austrian theory has a specific expression — shrinkage or shortening in the process of production.

It describes a shift in the economy's growth pattern from highly capitalistic output in manufacturing to labor-intensive output in services requiring little or no capital input. In essence, it reflects a shift in the demand pattern and resource allocation between consumption and investment. Unusually high consumer spending and the corresponding decline in the household saving rate curb the resources available for investment, crowding it out. It was in particular Friedrich Hayek who elaborated on this subject, ending with the conclusion that shrinking capital investment leads to depression. America is increasing its present living standard by lowering its capital investment and running up a mountain of foreign indebtedness.

Clearly, this implies a major downward shift in job quality and corresponding wage rates. The great joke is that the government's Bureau of Labor Statistics reports a productivity miracle for this time.

THE FALLOUT

When the equity bubble popped in 2000, the Fed's aggressive easing managed to supplant it immediately with the far more powerful housing bubble. An unprecedented borrowing binge, enabled by rising house prices, allowed the consumer to increase his spending despite sharply falling real income growth. At issue now is the aftermath of the housing bubble.

As to be expected, opinions about consequences vary widely. Hopes for a rather painless outcome rest mainly on the assumption that monetary policy will prevent a major decline in house prices and that most homeowners also possess large enough cushions of equity to continue their borrowing binge, though at a more moderate scale.

A second comforting assumption is that corporations, blessed with high liquidity and profits, will make up for any cutback in consumer spending by stepping up their investment spending. Another hope is that booming Asia will be resilient enough to decouple from a weakening U.S. economy, offering the possibility of higher U.S. exports.

FOUR DOWNSIDE RISKS

Pondering the possible or probable severity of the U.S. economy's post-bubble aftermath, it is necessary to take four different downside risks into account: *first*, the construction slump; *second*, the impact of falling house

prices on the balance sheets of private households and their lenders; *third*, declining equity extraction through mortgage refinancing; and *fourth*, international fallout.

First of all, it seems necessary to stress once more the fundamental difference between the present U.S. housing bubble and all its predecessors. All past housing bubbles were pure price bubbles without equity extraction for spending outside the housing sector. Borrowing-and-spending excesses were confined to building and trading houses.

This is, of course, a difference of utter importance. It goes without saying that the new kind of housing bubble, with massive equity extraction, exerts a far more profound influence on the economy than the earlier pure pricing bubbles.

CONSTRUCTION SLUMP

The impending reversal in the housing market shows its first effect in slumping residential building. In 2005, it had still provided 0.50 percentage points to real GDP growth. In the second quarter of 2006, it subtracted 0.63 percentage points, annualized. This is sure to continue.

But these are only its direct effects. Building is the GDP component with the largest indirect effects, so-called multiplier effects, affecting the economy in various ways in addition to the construction impact. According to calculations, the housing bubble in the past several years has, through the activity of real estate agents and the lending institutions, accounted for more than 30% of the increase in employment and income growth.

It is a reasonable assumption that the direct and indirect effects of the impending construction slump will reduce GDP growth by well over 1 percentage point of GDP. Considering, moreover, the unusually large housing inventory overhang, the downside of the bursting housing bubble could be deep and protracted, lasting for years.

BALANCE SHEET RECESSION

The soaring asset prices in the past few years have been crucial in enabling the prodigal borrowing and spending of income-poor private households. According to Fed statistics, housing values in 2005 rose by $2.66 trillion, against an increase in outstanding mortgages by $1.1 trillion.

What will happen to asset prices? That is the new big question. Asset inflations are self-feeding by providing the ballooning collateral for ever-higher borrowing. But the trouble is that such a fast-running credit machine comes to a standstill when asset prices flatten out. For the U.S. housing bubble, this day has arrived.

The general comforting view in the United States is that once the Fed eases, the economy will promptly take off again. We think a bursting bubble economy with plunging asset prices is not responsive to easy money. Japan's central bank for years has flooded its financial system with more and more excess liquidity and told everybody they could take money for free. Both consumers and firms have flatly refused to do so.

Plainly, the greatest monetary ease of all time in Japan has been stymied for years. The obvious reason is excessive debts and balance sheets devastated by collapsing asset prices. Some call it balance sheet recession. Stock prices have fallen 70% and real estate prices 85%. Repairing badly damaged balance sheets through debt repayment gained general preference to investment spending, essentially assuring the economy's protracted slow growth.

For the aftermath of a bubble economy, three depressive economic and financial legacies are imperative:* first*, a huge debt overhang;* second*, crashing asset prices devastating the balance sheets of lenders and borrowers; and* third*, spending borrowed from the future.

By far the greatest threat to a bubble economy is falling, if not crashing, asset prices, because that means immediate wealth destruction in home equity. Here the key point to see is the extraordinary laxity that has prevailed in mortgage lending for many years. In numerous cases, as reported, equity is already nonexistent, if not in reality negative owing to generous evaluations because there never was a down payment. Once house

prices start to decline, rapidly increasing selling pressure is sure to develop.

The big problem with sharply falling asset prices is the associated potentially massive wealth destruction devastating the balance sheets of homeowners and their lenders. What, then, results is protracted and very severe "balance sheet recession," against which monetary easing is powerless.

THE BORROWING BINGE AT STAKE

The biggest contribution to GDP growth in the past few years has accrued from the equity contraction financing consumer spending on things other than building. In 2005, inflation-adjusted consumer spending increased $264.1 billion. Real disposable incomes of private households grew, in comparison, only $98.3 billion. The difference between the two aggregates must be attributed to equity extraction. But as consumer borrowing increased by $1,241.4 billion, we presume that a far greater part of the borrowing was for unpaid interest.

At stake is not only the equity extraction from the housing bubble, but the total borrowing binge of private households. Its further development is the new big question. Asset inflation is self-feeding by providing the ballooning collateral for ever-higher borrowing. But the trouble is that this fast-running credit machine comes to a standstill when asset prices stop rising. For the U.S. economy, this day has arrived.

It is no secret how the crash of a housing bubble starts. Turnover and liquidity collapse well before prices, while houses for sale pile up. Apparent price stability can therefore be very deceptive. On the other hand, it has to be realized that a very small turnover in the housing market is able to wreak havoc with asset values in balance sheets.

INTERNATIONAL FALLOUT

Hopes are riding high that a "global rotation" shift will occur wherein Europe and Asia will avoid fallout from a slowdown in the U.S. economy. The underlying assumption is that, above all, the overheating Chinese economy has gained sufficient strength in the past few years to decouple from a weakening U.S. economy. As it continues to boom, it would even lend support to the U.S. economy.

Before taking a closer look at this idea, let us briefly recapitulate what happened to trade flows when the U.S. economy went into a very mild recession in 2001. This had an amazingly strong restrictive effect on U.S. imports. They fell by $78.5 billion, or 6.4%. At the same time, though, U.S. exports sharply declined for two years, from $772 billion in 2000 to $682.4 billion in 2002; i.e., by $89.6 billion.

For the U.S. economy, it turned out to be the mildest postwar recession. But the impact on many countries with high export ratios to the United States was extraordinary. Stock markets spiraled downward around the world and commodity prices slumped.

One country least affected was China. Its export boom to the United States had not yet started. Its overall trade surplus in 2001 amounted to $17.4 billion, after $20.5 billion in the prior year. Foreign reserves of its central bank had increased very slowly until 2000. Paradoxically, China's super-boom got kick-started during the worst years of the U.S. economy, in 2001–02.

China is a bubble economy of the same type as Japan in the late 1980s, but the imbalance between investment and consumption is a lot worse. Capital investment lately has been rising at a rate of 30% and accounts for 45% of GDP, against a share of 38% for consumption. Compare this with America's consumption share of 71%.

As capacity additions vastly outstrip domestic demand growth, economic growth depends increasingly on exports, as reflected in the soaring trade surplus with the United States. In 2000, the overall trade surplus amounted to $34 billion. Today, it is running at over $200 billion. In other words, China's dependence on exports has sharply increased since the U.S. economy's last recession, accounting now for 32% of GDP, of which 40% goes to the United States.

Manifestly, China is far more vulnerable to a U.S. recession today than it was in 2001. The question is whether a probable sharp slowdown in exports might prick the investment bubble. It has to be realized that a sharp decline in its surplus with the United States, correspondingly reducing the dollar inflow, additionally will act as a monetary squeeze, possibly driving up interest rates.

In the end, though, everything will depend on the severity of the U.S. recession.

CONCLUSIONS:

Trying to asses the U.S. economy's prospects, our first assumption is that the Fed keeps its money and credit spigots wide open. Betting on impending rate cuts, leveraged financial speculation has a new strong impetus.

The U.S. economy has a whole variety of asset bubbles. But the housing bubble is of special importance. With its two components, the housing construction bubble and the huge equity extraction bubble, it has been predominant in driving U.S. economic growth in the past five years.

But the house price inflation has collapsed under growing sales pressure. Recent prices are generally below their level a year ago. As bad news about the housing market is making more and more headlines in the media, one has to assume that selling pressure is bound to rise, while potential buyers are sure to exercise growing reluctance. Together, this will put house prices under growing downward pressure.

There are hopes that sinking bond yields and continuous gross liquidity excess will also revive the housing bubble. The decisive condition for that bubble to revive, though, is rising house prices. In our view, though, there is no chance for this to happen, owing to the rotten state of consumer finances. Weak balance sheets tend to frustrate monetary easing.

The problem is that the overall valuation of the housing stock depends on the price of the last trade, however small the trade may be. In this way, very small trades involving lower prices are able to cause massive destruction of net worth. Moreover, we doubt very much that at present inflation rates the Fed has significant scope for quick rate cuts. From this perspective, house prices are the early indicator of economic prospects.

Consumer confidence may get some relief from sharply lower oil and gasoline prices, but the rapidly unraveling and much more powerful housing market keeps the economy firmly in the grip of a pronounced slowdown. Besides, the falling commodity prices most probably also reflect slower economic growth.

There is widespread belief that easier money and global excess liquidity make a steep decline in house prices impossible. But the former excess liquidity in the market — borrowed liquidity — depended primarily on rising asset prices providing the collateral for the purchases. In absence of rising prices, this liquidity vanishes. It should also be clear that falling house prices will pull stock prices downward with them.

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